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SETTING A RECORD: THE PHOENIX EXPANSION

A 1987 MIDYEAR REVIEW OF THE U.S. ECONOMY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

BY THE

MINORITY MEMBERS

OF THE

JOINT ECONOMIC COMMITTEE

TOGETHER WITH

DISSENTING VIEWS

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LETTER OF TRANSMITTAL

JULY 21, 1987.

Hon. PAUL S. SARBANES,
Chairman, Joint Economic Committee,
Congress of the United States,
Washington, DC.

DEAR MR. CHAIRMAN: Transmitted herewith is the 1987 midyear review of the U.S. economy prepared for the Republican Members of the Joint Economic Committee by the minority staff.

This document, "Setting a Record: The Phoenix Expansion," examines the accomplishments of the past 56 months of economic growth, explores the prospects for continuing growth, and celebrates the historical significance of the current record-breaking peacetime economic expansion. A five year trend of steadily rising real income, employment, and productivity is particularly remarkable given the severe economic problems of the stagflation years preceding the recovery. The midyear review also discusses the renewed interest in economic and political theory which offers new insights on the U.S. Constitution, whose bicentennial we commemorate this year.

We Republican Members forward this report to the 100th Congress and the public with the desire to promote policies to lengthen, strengthen and broaden the economic expansion.

Sincerely,

CHALMERS WYLIE,
Ranking Member,
Joint Economic Committee.

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I. INTRODUCTION

Like "Old Man River" the economy just keeps rolling along. October 1987 will mark the 59th month of economic recovery and expansion, thereby setting the record as the longest U.S. peacetime expansion since World War II. And, according to the "Blue Chip" consensus of national economic forecasters, real GNP growth in 1988 will be even better than 1987.

This expansion is even more remarkable given, like the Phoenix, the ashes from whence it has risen. Prior to the beginning of the recovery in December 1982, the unemployment rate was over 10 percent (10.6 percent in November 1982), inflation registered its highest rate since 1947 (13.5 percent year-over-year in 1980), and the prime interest rate recorded its highest level in modern U.S. history (an annual average of 18.87 percent in 1981). As of June 1987, the unemployment rate stood at 6.1 percent, the inflation rate at 3.7 percent (12 months ending June 1987), and the prime interest rate at 8.25 percent. Real GNP growth in the first quarter of 1987 accelerated to a surprisingly strong 4.4 percent, and moderated 2.6 percent in the second quarter.

Credit for this dramatic economic recovery and persistent expansion is readily traced to the free enterprise foundation of our economic system and the Reagan Administration's adherence to sound economic principles. Back on the right track after years of malaise, this Nation is moving strongly toward continued future growth.

The budget and trade deficits remain serious concerns, not only because of their direct effects on the economy, but also due to the ways the Congress might react to them. Attempts to reduce the budget deficit by raising taxes, and efforts to cut the trade deficit by imposing unjustified and counterproductive protectionist trade barriers, will result in weaker economic growth. As the last 5 years should have taught us, the solution to the twin deficit problem is the promotion of higher economic growth—lower taxes, a further reduction in the expansion of government and freeing our economy to do what it is designed to do best—compete.

II. SETTING THE RECORD

Attaining an expansionary record can only be accomplished with robust and sustained performance across many sectors of the economy. The current expansion has accomplished such widespread strength largely through the Reagan Administration's adherence to sound economic principles. The steps outlined in 1981—implementing monetary policy to halt inflation, enacting tax rate cuts to halt the ill effects of bracket creep and heavy tax burdens, and reducing the Federal Government's size and involvement in the private sector—laid the foundation that spawned economic revitalization. Bolstered by confidence in bold leadership, in late 1982 the U.S. economy shook off the lethargic legacy of the stagflation years. Now, nearly 5 years later, America boasts the highest production, employment, and income figures ever recorded.

This chapter will present a review of the current economic expansion and compare and contrast it to economic performance since 1974. Growth has occurred during the past 12 years as the economy was adapting to considerable structural and functional change. On the structural side, the United States is now facing the challenges of a growing and internationalized economy where our relative clout and prominence have been diminished. Central to this is the role technology plays in our economy. The relatively easy transfer of technological applications across national borders has given American industry formidable competition where little existed a decade ago.

The emerging "information age" shows how the function of the economy has shifted in recent years. The virtual explosion in the use of computers, telecommunications, and microprocessors of all kinds has caused a revolution in how people work and what people buy. The information industry is not just computer programmers and telephone technicians. Bankers and accountants are information providers of financial information. Economists and policy analysts are gatherers and disseminators of economic information. Foremen on an assembly line interpret production and performance information to reduce costs and increase output. From this point of view, some research suggests the information sector—the production, storage, retrieval, distribution, and application of information—is not just the biggest employer, but could account for half of all U.S. jobs.

The free market is indispensable during this time of adjustment. No other economic system, chosen or coerced, could harness and deliver new economic inovation in a more efficient or equitable manner. The response of the American people—to seek opportunity rather than to resist or bemoan the challenges that change presents—is a tribute to our free market principles.

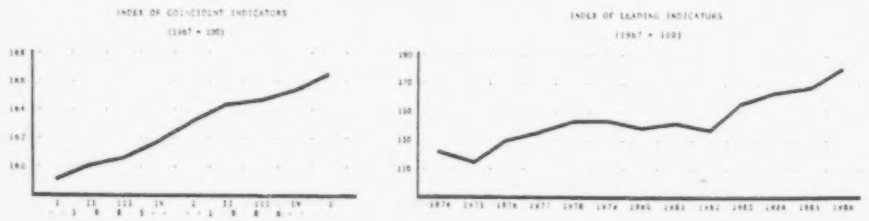
Economic Review

The Reagan expansion is continuing in mid-1987. It can be characterized as being in the "maturing" stage. Naysayers who discount the strength of the economy complain that 1986 economic growth of "only" 2½ percent is below historical trend. Compared to other countries, however, that figure was outstanding. This moderation in growth is on the heels of two years of exceptional growth and investment. Furthermore, it is far superior to the alternatives of a pause or a contraction.

The current rate of growth is providing a cushion of stability to the economy. Too-rapid growth could unnecessarily increase inflationary pressures and lead to employment shortages in certain sectors, particularly in industries demanding high levels of skill and training. The outlook for the near term—the next year or so—shows a continuation of current conditions.

The Composite Indices of Coincident and Leading Indicators are good gauges of the performance of and prospects for the economy. Chart II.1 illustrates the encouraging trends for these indices.

Chart II.1



The index of coincident indicators shows continuing, gradual improvement in the economy. The components of this index—employment, income, production, and sales measures—all have contributed positively to the overall index during the past 2 years. Employment gains have had the largest impact on the index. These components fluctuate over time, as market conditions change. Since January 1986, on a monthly basis, the four individual components individually have edged upward about twice as often as they have turned downward. The income component has been the most irregular during this period, moving positively and negatively an equal number of times. However, the net change in the income measure has been positive.

The index of leading indicators is the Federal Government's best economic forecasting measure. Over the past several business cycles, it foretold recessions about 8 months before they occurred. On that basis alone, the Reagan expansion will exceed 5 years' duration. Chances for an even longer expansion are excellent, because no consistent pattern of downturn has yet emerged, nor is it likely,

barring any major monetary contraction, inflationary surge, or destabilizing geopolitical incident.

This index is not universally embraced, nor is it flawless in design. Many experts argue that it focuses too heavily on the manufacturing sector. Consequently, it does not give enough emphasis to services, which is the fastest growing sector of the economy.

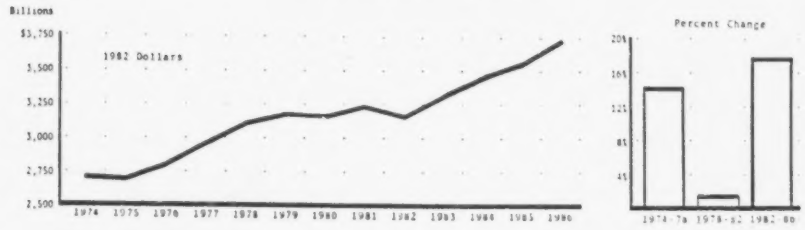
For analytical purposes, the leading index is divided into four subgroups: capital investment commitments, inventory investment and purchasing, profitability, and money and financial flows. The latter two categories have risen the most since 1982.

The individual components of the leading index also show fluctuation. In the months since January 1986, the "gainers" have outpaced the "losers" by a three-to-two margin. Two financial components have stood out as consistent positive contributors—the monetary measure (M2) and stock prices. Contracts and orders for new plant and equipment is another significant contributor, and one that portends favorable prospects for output and productivity, just as first quarter figures for GNP and labor productivity indicate.

Two components have not moved the index much in either direction: they are the average workweek of production manufacturing workers and the change in sensitive materials prices. Only one component, change in credit (business and consumer borrowing), has edged downward more months than upward.

Gross national product, the broadest measure of U.S. economic performance, has shown marked growth in the current expansion. Chart II.2 tracks inflation-adjusted GNP since 1974.

Chart II.2
REAL GROSS NATIONAL PRODUCT



As the chart indicates, virtually no improvement in real GNP occurred during the stagflation and recession years of 1978–82. Since then, real GNP has expanded 17.3 percent, a figure higher than the 4-year period of 1974–78, when real GNP improved by 14.1 percent. Real GNP continued on its upward path during the first quarter of 1987 as well, when a 4.4 percent annual pace was recorded. GNP growth for the first half of this year is 3.6 percent, a half-point better than recorded for all of 1986.

An analysis of GNP by industry reveals very interesting changes in the U.S. economy, as summarized by Table II.1.

TABLE II.1.—COMPOSITION AND REAL GROWTH OF GROSS NATIONAL PRODUCT BY INDUSTRY

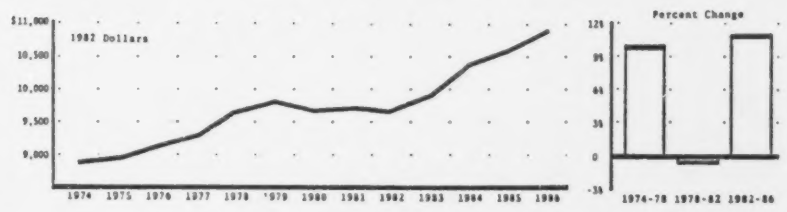
Industry	Percent of GNP [1]		Percent change			
	1974	1986	1974–78	1978–82	1982–86	1974–86
Total GNP	100.0	100.0	14.1	1.6	16.1	34.6
Agriculture, forestry, and fisheries	2.6	2.4	3.0	24.8	.1	28.7
Mining	4.8	3.2	−1.2	2.6	−10.6	−9.4
Construction	6.0	4.5	8.9	−20.3	17.8	2.2
Manufacturing	22.7	22.8	15.5	−7.1	26.5	35.7
Transportation and public utilities	9.1	8.8	14.5	1.3	12.3	30.3
Wholesale and retail trade	15.6	17.2	18.8	.8	25.0	49.7
Finance, insurance, and real estate	14.0	14.6	16.0	7.4	12.8	40.5
Services	12.7	15.3	18.5	12.6	21.3	61.9
Government	12.9	11.0	6.0	3.3	5.7	15.7

[1] Individual components do not add to 100.0 due to omission of the "Rest of World" component, residual and statistical discrepancy.
Source: Bureau of Economic Analysis.

This table indicates some important changes in the U.S. economy over the past 12 years. Only one of these major industry groups—mining—has actually declined. All others experienced growth. However, four industries grew slower than GNP overall, thereby losing their relative share of total GNP. In order of increasing growth, they are construction; government; agriculture, forestry and fisheries; and transportation and public utilities. The remaining four groups performed very well. In increasing order, they are manufacturing; finance, insurance and real estate; wholesale and retail trade; and services.

Personal income, too, has grown far better over the past 4 years than in the previous 8, but not quite as rapidly as GNP. Chart II.3 illustrates the 12-year trend in inflation-adjusted per capita disposable personal income.

Chart II.3
REAL PER CAPITA
DISPOSABLE PERSONAL INCOME

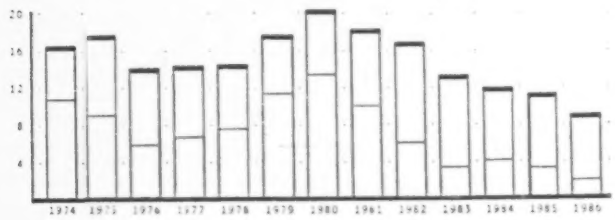


Due to the ravaging effects of inflation on income, the 1978–82 period witnessed a slight decline in real disposable income (−0.1 percent). In the 4 years following, however, this measure rebounded a strong 10.8 percent.

The "Misery Index" is a measure that was concocted during the 1976 presidential campaign to show the combined ill effects of inflation and unemployment. Continued reference to it after the election backfired on the Carter Administration, as the two measures worsened. Chart II.4 traces the Misery Index since 1987.

Chart II.4
MISERY INDEX

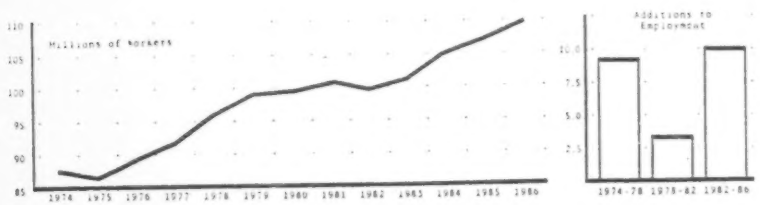
CPI + Unemployment Rate



Ironically, the Misery Index peaked in 1980, the next presidential election year. It has steadily declined since then, dropping below 9 percent last year—the lowest level since the index was devised.

The reduction in the unemployment rate since the 1978–82 stagflation-recession years has been steady and strong. But even more important are the remarkable gains in employment recorded since 1982. Chart II.5 looks at the employment picture from 1974 to 1986.

Chart II.5
CIVILIAN EMPLOYMENT



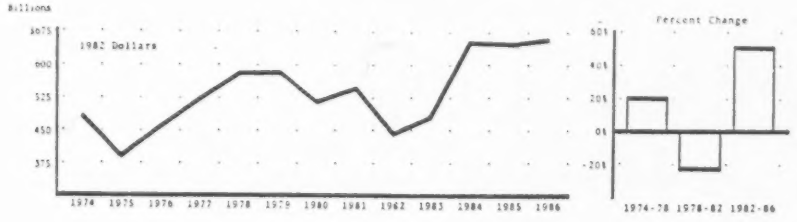
Civilian employment grew by 10.1 million from 1982 to 1986, after growing 3.5 million in the 4 previous years and 9.3 million in the 4 years preceding 1979. The demographic changes accompanying the maturing "baby boomers" have had a significant effect on labor statistics in recent years. The civilian labor force grew by 10.3 million from 1974 to 1978, about a million more than the increase in employment for the period. This differential between the labor force and employment got worse in the 1978–82 period. The labor force grew by 8 million, some 4.5 million more than the employment increase. Finally, this negative trend reversed after 1982, thanks to both slower growth in the labor force and a big jump in employment. Employment increases have exceeded labor force additions by 2.4 million during the Reagan expansion.

The civilian labor force participation rate has increased markedly in the current expansion as well. Its current level of 65.4 percent is a record high, up 1.4 points since 1982. Many labor experts believe this increase reflects demographic changes in the U.S. population. Another factor is new flexibility in the workplace enabling women new opportunities to earn an income outside traditional roles. Removal of existing work obstacles to women may allow even greater overall productivity. For example, many "information sector" jobs like data processing can be performed in the home or at different hours than an 8-to-5 schedule.

Strong economic growth and an administration committed to sound economic principles and policies to stimulate the private sector and to foster an opportunity-seeking society have strengthened business formation in the United States. In 1984, a total of 16.1 million businesses (proprietorships, partnerships, and corporations) were in operation. During the 1980's, the compound annual growth rate in the number of businesses was 5.4 percent. The decade of the 1970's had a slower but still respectable 4.5 percent compound annual growth rate.

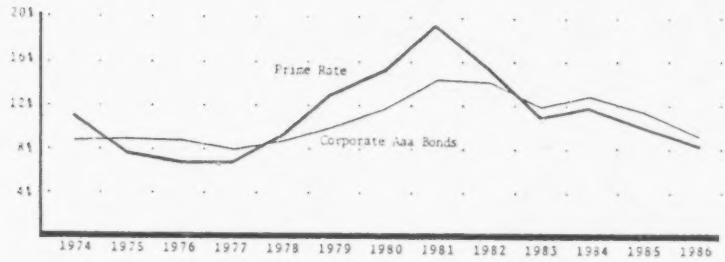
Private sector investment has been an outstanding feature of the Reagan expansion. Chart II.6 shows the dramatic turnaround in gross private domestic investment.

Chart II.6
REAL GROSS PRIVATE DOMESTIC INVESTMENT



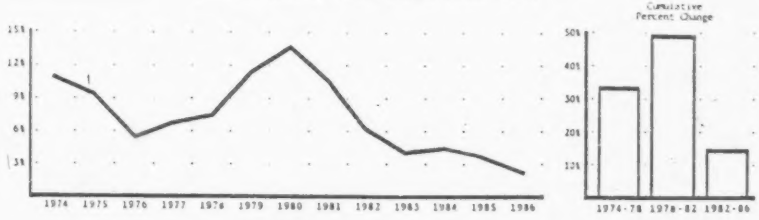
In the 1982–86 period, inflation-adjusted investment grew by 47.5 percent, after contracting a severe 22.5 percent in the preceding 4 years. The significance of the investment boom in this expansion is highlighted by the fact that investment grew a much slower 19.9 percent in the 1974–78 period. The investment boom is stimulated not only because of confidence in the economy and a healthy business climate: declining interest rates have made investment financing easier, too. Chart II.7 tracks interest rate movements for the prime rate and Moody's Corporate Aaa bonds.

Chart II.7
INTEREST RATES



Interest rates on a wide variety of financial instruments fell in 1986 to their lowest level in 8 years. Financial markets acquired a confidence absent for several years, due to the disastrous effects of inflation in the pre-1982 period. The much lower inflation rate of the Reagan expansion years shows a vast improvement over the 8 years previous, as indicated by Chart II.8.

Chart II.8
INFLATION
Measured by the Consumer Price Index



The 1986 inflation rate measured by the Consumer Price Index was just 1.9 percent, the lowest figure since 1965. Since 1982, the cumulative increase in the CPI has been 13.6 percent, a minuscule amount compared to a 48.0 percent increase between 1978 and 1982, and 32.3 percent between 1974 and 1978.

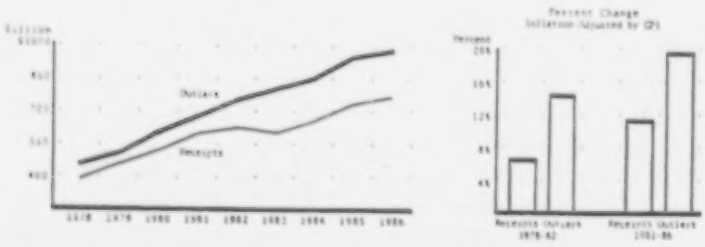
The Federal Government sector has introduced an element of imbalance to the U.S. economy over the past several years, but not at the expense of the expansion. The imbalance primarily is caused by runaway deficit spending and the swelling national debt. The root of the problem is the penchant of the Congress to spend money it does not have.

Since the Great Society days, the Federal Government has expanded its involvement in the economy at an alarming rate. Increased programs and entitlements were financed by higher taxes, money creation, borrowing and inflation. Increasing regulatory

burdens also hindered the economy. Consequently, economic growth was impeded by greater government intervention in the market. The price for years of noble intentions, less-than-fulfilled promises and unattainable goals was the period of stagflation and recession that was halted by the Reagan economic initiatives begun in 1981 and taking effect in 1982.

Chart II.9 traces Federal outlays and receipts.

Chart II.9
FEDERAL OUTLAYS AND RECEIPTS

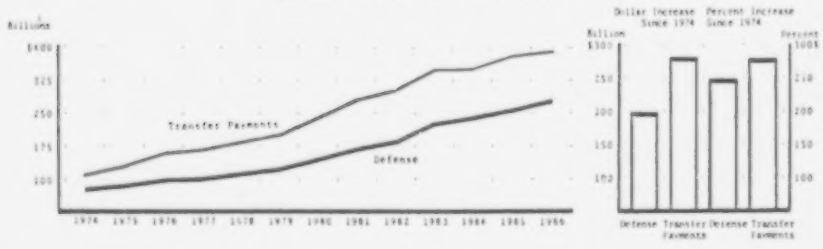


The revenue side is often cited as the cause for the budgetary shortfall. That perception is incorrect. Even though revenues declined slightly in 1983 as an aftereffect of the 1981–82 recession, the 8-year trend reveals that spending is the culprit. In real terms, Federal receipts have grown over time. From 1978 to 1982, receipts grew 6.6 percent. That growth actually *accelerated* to 10.9 percent from 1982 to 1986, contrary to popular wisdom. On the spending side, outlays grew 14.6 percent from 1978 to 1982 and jumped 19.1 percent from 1982 to 1986—far outpacing revenue increases and thereby proving that spending has caused the rise in budget deficits, not income tax rate reductions. This is also supported by the fact that Federal spending as a percent of GNP grew to about 25 percent, 4 or 5 points higher than the postwar average.

Politically motivated analysts blame the tax rate cuts of 1981 and the increases in defense spending for harmful budget deficits. Both of these excuses do not hold up to scrutiny, however. The decline in receipts in 1983 is traceable to declines in corporate profits and other cyclical considerations. Individual income tax revenue—accounting for half of all revenues—rose during the latest recession. Detailed analysis shows that tax rate cuts stimulated growth that resulted in a larger tax base and therefore higher, not lower, revenue.

The Reagan defense buildup has been overstated by its opponents. To provide a benchmark, Chart II.10 compares defense spending and transfer payments.

Chart II.10
FEDERAL OUTLAYS FOR
TRANSFER PAYMENTS AND DEFENSE



Opponents of defense increases often complain that transfer payments have suffered at the expense of the military budget. That is wholly untrue, in either dollar or percentage terms. Since 1974, defense spending has increased $196 billion. In the same 12 years transfer payments ballooned $278 billion. Only since 1984 has the increase in defense spending been greater than the increase in transfer payments. In 1986, the defense increase was just $1.6 billion more than that for transfer payments—hardly the nightmare abandonment of "people programs."

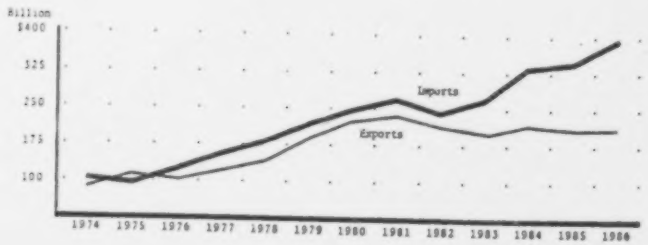
Trends in saving have made the budget deficit a challenge to finance without depriving the private sector of investment. Personal savings, which fell from $169 billion in 1985 to $114 billion in 1986, is often cited to raise concern. Other broader measures have not dropped as sharply, however. Gross private saving, for example, was $680.5 billion, a 1.1 percent decrease ($7.3 billion) from 1985. This measure shows that almost all of drop in personal savings was absorbed by other forms of saving which increased, such as corporate profits and inventory and depreciation adjustments. The 1986 level for gross private saving was still higher than the 1984 level, and exceeds the 1983 level by an impressive $195 billion.

Other analyses suggest that saving statistics alone do not explain the condition of U.S. finance. Wealth accumulation deserves consideration as well. In this regard the financial health of the U.S. economy has improved markedly, too. From 1980 to 1986, wealth expanded 53.3 percent, adjusted for inflation. Debt grew by 52.0 percent during the same period. In contrast, the decade of the 1970's witnessed the perilous trend of debt growth outstripping wealth growth by a huge margin—44 percent for debt versus just 18 percent for wealth.

Net capital inflows have made up for domestic saving shortfalls, another trend new to the 1980's. As a percent of GNP, net inflow at 3.5 percent in 1986 was slightly more than government dissaving, which was 3.4 percent. Through 1985, most of this shortfall reflected a decline in U.S. capital outflows, particularly bank lending to Third World Countries.

Another obvious area of imbalance during the Reagan Administration is international trade. The sobering balance of payments situation has prompted calls for retaliation and protectionism. While a lower trade deficit is important politically, it has not dampened the overall economy demonstrably. The flood of imports has been a natural and pronounced response to the capital inflow and the strength of the current expansion. The gap has been caused mostly by the lackluster performance on the export side caused by slow growth abroad and higher U.S. export prices from a generally higher exchange rate for the U.S. dollar. (See Chart II.11.)

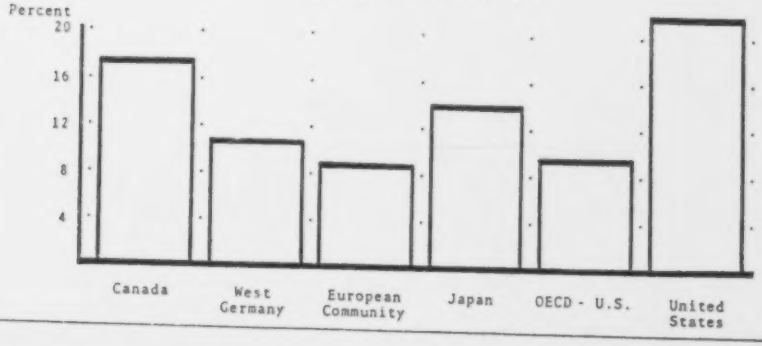
Chart II.11
MERCHANDISE IMPORTS AND EXPORTS



The value of the dollar and fears of declining U.S. competitiveness are often-discussed and valid reasons for the export problem. Another aspect directly relates to the U.S. expansion: no other country has matched our economic performance, and therefore their demand for goods and services—domestic or foreign—has been lackluster. Chart II.12 shows how domestic demand has varied among leading industrial nations from 1982 to 1986.

Chart II.12
REAL DOMESTIC DEMAND

Percent Change 1982-1986



Adjusted for inflation, domestic demand in the United States has increased 20.4 percent. By comparison, the figure for the European

Community grew only 8.8 percent; West Germany, 10.6 percent; and Japan, 13.6 percent. Only Canada came close to the U.S. pace, with a 17.0 percent increase. The combined growth for all nations of the Organization for Economic Cooperation and Development (OECD) excluding the United States was just 9.1 percent—*less than half the U.S. pace.*

Setting the Record Straight

The Reagan expansion is a notable achievement deserving recognition. But economic growth alone is not enough to satisfy the social, economic, and political goals that have made the United States the most powerful and diverse nation in history. Another indicator of the strength and reach of the current expansion is the distribution of its benefits to the citizenry. In this regard, the past 5 years have delivered opportunity and reward in abundance, contrary to some erroneous reports. With respect to income and wealth distribution, poverty, tax burdens, job creation, and regional economic performance, the Reagan expansion has not been imbalanced, unfair, or misguided. Society has prospered as the market has responded to a healthier business and working climate. This section refutes several of the glaring misperceptions that have been reported by many news sources in recent months.

Income Distribution

The inflation-wracked 1978–80 period diminished the purchasing power of households dramatically. Combined with the economic slowdown of the two recessions from 1980 to 1982, real household income took a beating. Demographic factors contributed to the decline as well. The number of households grew significantly when the "baby boom" entered the adult world. New households quite naturally are comprised of younger and less experienced entrants to the work force and thereby are in the early stages of income earning.

Inflation-adjusted median household income fell by 9.5 percent from 1978 to 1982. Since then it has improved steadily. The measure rebounded by 5.1 percent from 1982 to 1985, the latest year available. More growth is expected to be reported for 1986.

The distribution of household income has shown improvement, too. While much attention has been focused on the fact that the proportion of households in upper income brackets has increased, little attention has been given to the fact that the portion of households in lower incomes has been reduced and continues to shrink. From 1980 to 1985, the proportion of households with comparable real incomes under $20,000 fell from about 43.8 percent to 42.5 percent.

Poverty

Reductions in the poverty rate have been steady since the end of the stagflation years. The official poverty rate for 1985 was 14.0 percent of the population, down from the 1983 level of 15.3 percent. This income measure does not include non-money and in-kind forms of assistance, such as food stamps, housing allowances, and

medical care. This assistance elevates living standards considerably, and including the dollar value of these benefits reduces the proportion of households in lower income brackets. The market value approach is a measure which accounts for non-money benefits. Using this measure, the poverty rate is lowered to 9.1 percent in 1985, down from 10.3 percent in 1983. About 22 million persons—one-third of whom are children—resided in poverty in 1985 by this definition.

Poverty of any number or serverity is regrettable and undesirable. Empirical evidence shows that further reductions in the poverty rate require increasingly larger sums of money and support to accomplish the task. Inflation-adjusted welfare assistance per capita was about $50 in 1966 and over $200 in 1984; despite that fourfold increase in aid, only marginal progress was made. Eliminating poverty is elusive. Social assistance must address the need both to reduce physical discomforts and to promote self-reliance, initiative, education, and independence.

Federal policies toward poverty and welfare since the 1960's have not reached their intended goals. At the beginning of the "great society" program, many policymakers spoke strongly and appropriately against income transfers to eradicate poverty. Poverty was to be fought by providing skills for and access to the labor market. In practice, however, programs to motivate, educate, train, and employ the "structurally disadvantaged" were neither cost effective nor particularly successful. Thus, the "quick fix" of income transfers was revived to give the appearance of success, causing a welfare dependence and undesired "work penalty" effects accentuating the poverty problem today. The 100th Congress has recognized the deficiencies of current welfare programs, and the concept of welfare reform is receiving bipartisan support. The price tag for ineffective welfare policy is about $140 billion per year for all Federal, State, and local programs. The cost to society is the additional burden on taxpayers, foregone opportunities associated with alternative uses for public funding, and the danger of dependence of able-bodied and able-minded individuals on welfare.

The Republican Views of the 1987 *Joint Economic Report* outlined six practical steps to improve the current welfare system and to reduce the disappointing incidence of poverty in America. As the Congress continues its deliberations on welfare reform this year, the incorporation of those steps could make a contribution toward the goal of reducing poverty.

Wealth

A year ago, erroneous information on the distribution of wealth was given much publicity and attention. This account stated that the share of wealth owned by the richest citizens had leapt by 40 percent between 1963 and 1983. After correcting for a data entry error which resulted in a $1 trillion distortion, in reality, wealth concentration has remained virtually unchanged for 20 years by conventional measure. Despite the fact that individuals' wealth today is no more—*and most likely less*—concentrated, this emotionally and politically charged issue still is misconstrued.

The distribution of wealth today has been improved considerably by the increase in pension fund assets in recent years, a source of wealth uncounted by last year's faulty study. This omission amounts to over $1.3 trillion, or about one-sixth the value of the wealth considered in the earlier report. Some analysts suggest that 70 percent of pension assets belong to the lowest 90 percent of wealth holders. The inclusion of pension funds in the wealth base of the Nation would show a dramatically broader redistribution of wealth over the past two decades. In addition, the capitalized value of accrued Social Security benefits is another valid source of wealth that was omitted. Including it would reduce further the concentration of wealth.

Tax Burden

If partisan rhetoric is to be believed, the rich got all the benefits of tax reform and aren't paying their fair share. The little guy has once again taken all the lumps. Nor does the tax system remain progressive any more, since tax rates have been reduced. These and other doomsayer myths should be dismissed once and for all. The evidence clearly shows that our Tax Code has emerged from the last 5 years of revision as a fairer, more equitable and more economically efficient system.

The tax reform achievements of the Reagan Administration and the Congress since 1981 are astounding. The Economic Recovery Tax Act of 1981 (ERTA) halted the ill effects of "bracket creep," where inflation-induced income increases forced taxpayers into ever-higher tax brackets. The Tax Reform Act of 1986 went further in clamping down on noncompliance and tax evasion, reducing or eliminating abusive tax sheltering and other "loopholes," and reducing tax rates on all income levels. Tax rate reductions have eliminated 3 million low-income households from the income tax rolls and reduced taxes significantly for another 3 million.

If ERTA truly was a "giveaway to the rich" as its detractors contended, why have their tax liability, effective tax rates, and proportion of total income tax collections increased since 1984? Statistics released by the Internal Revenue Service verify that the highest income classes have had a burden shifted onto them as never before, even when marginal tax rates were 70 percent 6 years ago or 91 percent as they were in the early 1960's.

The Job Market

Espousing the view that job creation during the Reagan expansion has been lacking in both qualitative and remunerative terms is grossly unfair and inaccurate. Contrary to the pessimists' view of the good news, most of the remarkable 13 million increase in jobs since the end of 1982 are not dead-end, part-time, low-skill and unrewarding. These new jobs denote opportunity at all levels and across most sectors of the economy.

Over 60 percent of the increase in employment has occurred in the highest paying category (median weekly full-time earnings of $390 or more in 1986 dollars). These are in professional and managerial occupations. According to the Bureau of Labor Statistics, only 12 percent of the new jobs have been in the low-skill, low-pay

category, mostly in services. Furthermore, 92 percent of these new jobs are full time. Although a relatively high share of part-time employees desire full-time work (5 percent in 1986), this figure has fallen steadily since its peak in 1982.

And let's give credit where it is due. The Federal Government can *not* take credit for the impressive employment record of the expansion. The private sector alone has created job opportunities. The jobs program of 1982 was not implemented until a year later, after the expansion was underway. Western Europe provides an excellent example of government intervention in the labor market. Since 1970, U.S. civilian employment has grown an astounding 31 million, or 38 percent. During the same 16 years, Europe's labor policies of plant regulation, hiring rules, firing protections, and other blatant interferences have spawned little new employment and negligible growth. While our unemployment rate has fallen significantly since 1982, Europe's has become worse. The public sector prescription for manipulative labor policies and fine-tuned economic growth just doesn't work.

Regional Economic Performance

Two sectors of the economy have not participated fully in the current economic expansion—agriculture and energy. The public has the perception that another sector—manufacturing—also has been declining, due to publicity about plant closings and job losses. However, many manufacturing industries have been growing during the current expansion, resulting in a net gain for the sector.

The sectors listed above have a regional concentration, causing some analysts to suggest that the U.S. economy is undergoing a regional shift. Plains States have been hit hard by the agricultural recession. The energy states of the West South-Central and Mountain States have felt a severe contraction. Traditional manufacturing industries of the Midwest have suffered economic and employment losses. This is in contrast to an economic boom in the South.

Regional differences in performance are not new, however. They have occurred in all of the economic expansions since the 1950's. In the 1960's, the South Atlantic States led the Nation in personal income growth. In the early 1970's, the Mountain States led the regions. During the rest of the 1970's, the West South-Central States performed the best, and the 1980's have seen the South Atlantic reappear as the growth leader.

Population shifts and composition have had an influence on regional growth. The effects of the maturing "baby boom" are not yet completely known. A growing, wealthier and more mobile retirement-age population also will have a pronounced regional effect as they seek the benefits of scenic and temperate areas that are creating resort industries. Energy and agriculture are internationalized industries. The United States no longer has commanding influence over market conditions, which are plagued by elements such as cartels controlling price and output, and heavily subsidized production coupled by import protection. These actions defy free market principles; therefore, remedies are complicated.[1]

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[1] For further reading, see the 1987 *Joint Economic Committee Report*, U.S. Congress, pp. 156-166.

Summary

Analyzing information on the U.S. economy requires a considerable amount of vision and foresight in the 1980's. Comparing the American economy to the one of 20 or even 10 years ago is not easy and, in many respects, is not relevant, either. The traditional American giants of industry—steel, autos, and textiles—are being challenged by the emerging giants of the information age—computers, communications, and high-tech applications. This challenge is helping to create the opportunities for tomorrow.

III. SURPASSING THE RECORD: OUTLOOK AND POLICY CHOICES

Ours is a political economy—a profit seeking economic system tempered and guided by a universal suffrage constitutional republic. In its shallowest sense our constitutional democracy is propelled by partisan politics and the inherent conflicts created by the constitutional separation of powers within government. In the short term, oftentimes it is difficult to see how partisan conflicts can possibly yield a net gain for our democratic/capitalistic way of life. But they do. Such is the current political environment particularly with respect to fiscal (taxation and spending) limits and priorities and our role in global affairs. Policy choices with respect to money supply growth and raising the minimum wage are also sensitive political issues with serious economic consequences.

Budget Outlook

As we have pointed out previously, the budget situation has improved considerably over the last 18 months. Instead of the growing budget deficit previously projected, the deficit has plunged $60 billion in fiscal year 1987. This swing in the the budget outlook has been caused by a slowdown of Federal spending growth in the face of increasing revenues under current law.

Beyond fiscal 1988, prospects for deficit reduction are unclear. Though not declining in absolute amount according to recent preliminary CBO estimates, the deficit would decline to 2.6 percent of GNP by fiscal 1992 under current policy. This situation provides an opportunity for Congress to put its fiscal house in order and strengthen and lengthen the expansion. Enacted reductions in the growth rate of Federal spending would further reduce the deficit.

According to CBO, Federal revenues over the next 5 fiscal years will rise an average of $68 billion annually. By fiscal 1992, about $340 billion will be added to baseline revenues. The central problem is that over the same period Federal outlays are also projected to increase by about $68 billion per year.

It will be recalled that the budget projections are sensitive to changes in economic and technical assumptions. Though the budget outlook is too uncertain for complacency about the fiscal position of the Federal Government, it is encouraging in the sense that feasible measures to restrain spending growth could significantly reduce the deficit.

The emergence of the improved budget outlook is largely attributable to the attitude reflected by the adoption of Gramm-Rudman-Hollings (G-R-H) legislation. In 1985 Federal spending surged $94.5 billion, the largest 1-year increase in American history. After enactment of G-R-H, however, the pace of Federal spending growth fell sharply.

But policy actions which push Federal outlays higher can erase or reverse the recent improvement. Tragically, it seems that an across-the-board increase in domestic spending already is being promoted by representatives of various special interest groups. If the 100th Congress succeeds in evading G-R-H, this will strengthen the argument that fiscal discipline can only be imposed by constitutional amendment.

Control of Federal spending and deficits is important for long-term economic growth and a higher standard of living. Each expansion of Federal spending must be financed by taxation, borrowing, or inflation. Whatever the means of finance, the effect is to transfer private sector resources to government uses. In other words, funds that would be devoted to economic growth—such as private saving, investment, and consumption—are instead used for government programs. Unless the value of the additional government expenditure exceeds that of the private use, which is crowded out, the increased Federal spending decreases overall economic welfare.

While the benefits of some government programs exceed their costs, this is clearly not always the case. At the margin each dollar spent by government is $1 less available to the worker, farmer, small businessman, and consumer. At some point, government spending and taxation become excessive and more government becomes a burden upon the people. We believe this point has been reached and that the upward trend in the share of economic resources devoted to government must be contained. By freeing a greater share of resources available to the private sector, Federal spending restraint will permit increased economic growth and a higher standard of living.

Public Choice: The Application of Constitutional Economics

As America celebrates the Constitution's bicentennial, it is appropriate to consider recent advances in social theory that have improved our understanding of this document. Much of this progress is associated with economists. For example, F.A. Hayek and James Buchanan, both recipients of the Nobel Prize in Economics, have each generated original and provocative analyses of constitutional issues. Though using different approaches, both have reached conclusions in keeping with the spirit of the Federalist philosophy embraced by most of the Founding Fathers.

That spirit acknowledges human fallibility in government and supports the principles of limited government, individual freedom, and equal justice under law. As Madison stated:

> If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.

In recent decades the Federalist attitude has been eclipsed by increasing idealism about the ability of government to foresee and solve complex economic and social problems. The theoretical possibility of "market failure" was used to justify government intervention in a wide range of activities. Some even argued that government could "fine tune" the economy to achieve targeted levels of

economic growth, unemployment, and inflation. However, the attempts to fine tune the economy were not successful, and ended in the late 1970's experience of rising inflation and unemployment. According to Hayek, the presumed rationale behind such policies as "fine tuning" is based on the assumption that government officials possess more information than they actually have; he calls it "the pretense of knowledge." The broadly perceived failure of fine tuning undermines the belief that extensive government intervention can improve economic welfare. Consequently, Americans today are more aware of the potential of "government failure," and have tended to support measures to reduce tax rates, to curtail excessive regulation, and according to polls, to require a balanced budget/tax limitation constitutional amendment.

In addition to economic concerns, Hayek also argues that the observance of constitutional limits are essential to preserve the integrity of democratic government. Limited government means that state intervention is strictly confined and that official actions aim at the uniform application of rules and procedures. In other words, discretionary actions favoring specific groups are to be minimized. Under this framework, the potential for gain by bribery and corruption is limited. Moreover, the energy and attention of public officials can be concentrated on performing functions enjoying the broadest support.

However, when the scope of government actions expands to benefit discrete groups of citizens at the expense of others, the potential for consensus or compromise on policy becomes progressively more difficult. At some point in this expansion, democratic processes become increasingly unable to reconcile the conflicting claims of the growing numbers of special interest groups. Voters respond by becoming cynical about democratic institutions, and special interests redouble their efforts to win favored treatment. When politics is viewed primarily as a means for some groups of citizens to exploit others, the integrity of the democratic system is jeopardized. This is only one reason why excessive government intervention is undesirable.

The Founders were well aware of this threat that coalitions of special interests, which they called factions, posed to democracy. Madison stated in the *Federalist Number 10:*

> Hence it is that such democracies have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security or the rights of property; and have in general been as short in their lives as they have been violent in their deaths.

The solution, as Madison saw it, was to contain and channel the influence of factions. The structure of the Constitution was designed to prevent hasty enactment of ill-considered measures favored by transitory coalitions of special interest groups. However, the Constitution is not perfect, and special interests clearly are able to exert considerable influence. Fortunately, a coherent body of thought has been developed which permits analysis of economic policymaking in democratic institutions—public choice. Public choice may be viewed as a restatement and refinement of the Federalist heritage, which had been ignored for decades.

According to Buchanan, "public choice is the analysis of political decisionmaking with the tools and methods of economics." Politics

is viewed not primarily as a means of establishing truth or justice in the abstract, but principally as a type of exchange process. The fiscal policy results of democratic decision processes are conditioned by the constitutional and nonconstitutional rules under which decisions are made.

For example, for most of American history budget deficits were considered unacceptable by politicians of major parties, except in emergencies. By holding the level of Federal outlays at the level of revenues, this rule acted as a spending constraint. The belief in balanced budgets was so strong as to be considered part of the unwritten constitution.

However, with the popularity of Keynesian economics, the taboo against deficit spending was broken by the early 1960's. Though not intended, the practical result of this development was to loosen the constraint on Federal spending growth in good times as well as bad. The tremendous pressures generated by coalitions of special interest groups pushed Federal spending even higher. There were few problems which could not be placated by the establishment of some policy or regulation and oftentimes spending vast sums from the public treasury.

The erosion of the balanced budget norm suggests the need for formal adoption of a balanced budget/tax limitation constitutional amendment. Special interest pressures upon legislators in support of expanded constituent programs could then be contained, with a restoration of fiscal responsibility. This reform would shift the burden onto program advocates to show that the value of their proposed expenditures is at least equal to that of other programs that would have to be cut back, or alternatively, to the costs imposed by additional taxation. In other words, the potential benefits of new expenditures would have to be balanced with their costs. This would require policymakers to choose budget priorities in keeping with the level of projected tax revenues provided by law.

By enactment of Gramm-Rudman-Hollings, Congress acknowledged the validity of the problem identified by public choice. It remains to be seen whether this statute will be strong enough to withstand the strong pressure of domestic spending constituencies.

It is a mathematical fact that 51 percent of the voters can elect a Member of Congress, and 51 percent of both Houses of Congress can pass a bill. Thus, barely 25 percent of the citizenry can conceivably advance their interest at the expense of the other 75 percent. The purpose of institutional reform is to constrain this ability of special interest coalitions to dictate policy. This is why the Administration has proposed an "Economic Bill of Rights" that includes a constitutional balanced budget amendment and a congressional super majority vote to enact tax increases.

Under present institutional arrangements it is more likely that a "tax and spend" approach will be adopted rather than rejected by Congress. Because the tax cost of Federal programs is diffused among all taxpayers, and the benefits concentrated among particular constituencies, it follows that support for additional spending will be more intense and thus successful in attracting the support of special interest beneficiaries. The overwhelming probability is that any new taxes will not be devoted to deficit reduction, but will instead stimulate another round of increased Federal spending.

History clearly shows that tax increases only tend to undermine economic growth and spur spending, not shrink the deficit.

U.S. Trade Policy in the Context of Economic Growth

This year should bring in its wake some modest but significant improvements in U.S. export performance and consequently, domestic economic growth. The depreciated U.S. dollar is already helping to boost exports. In volume terms, U.S. nonagricultural exports actually rose by 5 percent in 1986; by the fourth quarter of last year they stood 9 percent above the level of the previous fourth quarter. The U.S. Department of Agriculture is projecting a 15 percent increase in the volume and a 5 percent increase in the value of agricultural exports this year over last year. Consumer and capital goods exports are also on the rise. In fact, yearend (1986) GNP growth in the United States was largely the result of improved American trade performance.[1] If this trend continues, our relative trade imbalance should decline.

Improving U.S. International Competitiveness

The U.S. economy is well positioned to compete in the global marketplace. In large measure this is because of underlying domestic economic strengths. The United States is in the 56th month of an economic upturn. This dynamism is reflected in low unemployment and inflation, combined with robust job growth—all of which contribute to an environment supportive of business formation and investment. In terms of U.S. international sales there is also the advantage of dollar depreciation, which has gradually served to reduce the price of exports.

Microeconomic factors also deserve consideration in assessing America's future export capacity. Labor costs and productivity, each of which directly influence U.S. competitiveness, have recently posted significant improvements. The Bureau of Labor Statistics reports that unit labor costs for U.S. manufacturing *fell* an average of 0.8 percent annually from 1982 through 1986, in contrast to the 8.7 percent annual increase from 1978 to 1982. Productivity in U.S. industry has accordingly increased by 4 percent over this same period. In some sectors—including autos, copper processing, cement, tires and rubber, and steel—productivity grew by an impressive 6 percent.

International Economic Policy for Expanded World Trade

The foremost international economic policy goal of the United States should be to promote the expansion of world trade. Doing so provides the best longrun guarantee for helping the United States stimulate its merchandise exports by promoting the development of foreign markets for American products—and for those of other countries. Trade remains the most important growth catalyst in the world economy. Since 1945, combined world exports and imports annually grew between 1 and 2.5 percentage points faster than gross national product. This is because trade expansion gener-

[1] The New York Times, May 12, 1987.

ates domestic growth by putting each country's resources to their most productive uses.

Unfortunately, the prospects for expanded world trade are threatened by the persistence of protectionist barriers and distortions to trade in both the developed and developing world. Of course, these practices vary. In Japan they take the form of hidden procurement barriers which effectively shut out foreign competition. A case in point is the $8.5 billion worth of construction projects involving Japan's Kansai Airport in Osaka Bay. With a few minor exceptions, only bids submitted by domestic Japanese firms are being considered.

In the European Community, the most egregious barriers are found in myriad export subsidies, whose purpose is to capture foreign markets—from agriculture to commercial aircraft (Airbus). Meanwhile, throughout the Third World, a variety of tariff and nontariff barriers have been erected in order to shield uncompetitive industries from foreign, including U.S., competition. Severe balance of payments difficulties confronting these countries have, if anything, strengthened the tendency to close off domestic markets to imports. Nor is the United States immune to protectionism. U.S. trade policy should seek to improve the climate for expanded world exports for world economic growth.

Multilateral and Bilateral Negotiations

Multilateral trade negotiations constitute another means for opening up markets to U.S. exporters. The present Uruguay Round, convened under the auspices of the General Agreement on Tariffs and Trade (GATT), constitutes a case in point. Initiated in September 1986, these negotiations could expand GATT discipline into new areas and result in substantial trade expansion. The Uruguay Round is particularly important for U.S. exporters because it is designed to address two key American concerns of the 1980's: the establishment of new rules to help ensure fairer trade in services (insurance, telecommunications, and banking), and the phased reduction in agricultural export subsidies. In addition, unlike earlier GATT rounds, powerful Third World trading countries, such as India and Brazil, are directly included in the talks. If past experience is any guide, these various undertakings will help foster a political environment conducive to trade expansion.

Enhanced access to foreign markets can also be obtained through bilateral market opening negotiations. On the bilateral front, the United States has entered into a Free Trade Agreement with Israel, providing for the phased removal of tariff and some nontariff barriers. A more ambitious negotiation involves the United States and Canada, each of whom constitutes the largest market of the other. The goal is to eliminate existing tariff and nontariff trade barriers between the two continental partners.

Unfair Trade Practices Under Section 301

Resorting to protectionism hardly constitutes a viable economic strategy for the world's largest, most dynamic economy. An estimated 5 million U.S. jobs alone directly depend on export business—not to mention the indirect commercial and financial links

binding this country to the global economy. Rectifying existing trade practices is another matter entirely, however. In this arena, the United States has ample justification to continue demanding fairer access to foreign markets. Vigorous application of "unfair trade practices" cases brought under Section 301 of the Trade Act of 1974 has been very effective. More than 60 percent of all Section 301 cases have been launched under the present Administration, eight of them since September 1985 alone, of which seven have been satisfactorily resolved. Particularly significant breakthroughs involving successful resolutions of 301 cases include:

- Taiwan's agreement to open the domestic beer, cigarette, and wine markets of U.S. exports. This action creates the possibility of up to $150 million in additional commodity sales.
- Korea's willingness to eliminate prohibitions against insurance underwriting by American firms, thus enabling U.S. companies to fully enter Korea's $5 billion insurance market. Similarly, Korea has agreed to offer greater protection for U.S. intellectual property rights, involving copyrights, trademarks, and patents.
- A European Community (EC) decision to provide full compensation to the United States for higher corn and sorghum tariffs imposed in Spain following its accession to the EC. The subsequent compensation package of $400 million guarantees imports of 300,000 metric tons of sorghum and 2 million metric tons of corn by Spain. An additional 400,000 metric tons of grain may also be sold in Portugal; this comes about through the elimination of the requirement to reserve 15 percent of the domestic market for grain sales from other EC members. The Community has also agreed to lower tariffs on 26 other items.[2]

Reform of U.S. Trade Law

Sensible revisions of U.S. trade statutes constitute another approach to dealing with unfair trade practices and/or injurious import competition. Since the early 1980's the domestic U.S. economy has become more vulnerable to trade disruptions. While American consumers, for example, have greatly benefited from low-priced imports over this period, some industrial communities have been unable to absorb high levels of unemployment. Accordingly, under these adverse circumstances, the U.S. goal should be to revise America's trade laws to encourage domestic adjustment while maintaining the national commitment to expanded trade. This can partially be addressed through some statutory changes, including (1) revisions of Section 201 of the Trade Act of 1974 to encourage adjustment and expand the range of relief remedies available to the President; (2) imposition of firmer time limits in settling all "unfair trade practices" cases brought under Section 301 of the Act; (3) stronger laws against imports which infringe U.S. patents and violate intellectual property rights (e.g., copyrights and trademarks); and (4) tightening of U.S. laws which permit the President

[2] Office of the U.S. Trade Representative: The President's Trade Policy: An Update, Apr. 7, 1987.

to act against imports which threaten an industry critical to national security.

Enhanced U.S. competitiveness also requires a commitment by U.S. firms to expand their export market shares. As Robert D. Hormats, vice president at Goldman Sachs & Co., said before the JEC earlier this year, "Old habits die hard. American industry has increasingly come to recognize that its survival depends on meeting international competition. This has been recognized only slowly in some cases because of the habit of relying heavily on the large American domestic market." Indeed, it will become increasingly necessary for U.S. businesses to consider the international market as a natural extension of the domestic market if they are to survive and prosper in the 1980's and beyond.

The past few years have witnessed some erosion of U.S. export competitiveness. But our underlying comparative advantage in global markets remains strong across a range of items, running the gamut from commercial aircraft, pharmaceuticals, petroleum refining equipment, electronic computing, and medical equipment. There is also a growing foreign market for U.S. services, notably in sales of engineering and legal services, data processing, banks, airlines, along with income derived from franchising fees and technology licenses. None of these favorable factors—from downward shifts in the dollar's exchange rate value to market opening negotiations—guarantee expanded U.S. export market shares. In providing increased overseas market opportunities for American firms, however, the odds on such a favorable outcome will certainly improve, thus strengthening our economic expansion.

The Global Economy

A return to balance in the U.S. trade account also depends on the willingness and ability of our partners to play a larger role in stimulating future global expansion. Dollar depreciation does not automatically translate into new sources of demand outside the United States. As a study by the National Association of Manufacturers (NAM), explains, "Even favorable exchange rate developments cannot overcome business cycle differentials in aggregate demand that are a primary determinant of short-term U.S. trade flows. Despite slower GNP growth, effective demand in the United States has continued to outpace the recovery of demand in many of our trading partners * * *. And growth in many foreign countries continues to be strongly dependent on exports to the U.S. market." [3] Indeed, over the past 5 years, most of our trading partners have relied on sales to this country for between one-fourth and one-half of their domestic growth. This trend alone largely explains why U.S. merchandise imports grew from $273 billion to $387 billion from 1981 and 1986. Stepped up growth in demand by America's trading partners, then, constitutes one obvious way for the United States to close its trade deficit.

Prospects for global expansion—outside the United States—remain uncertain. This situation is the result of many factors, including global overcapacity, falling commodity prices, Third World

[3] The Record U.S. Trade Deficit of 1986, March 1, 1987, p. 2.

debt, and growing unease within Japan and West Germany about the course of their own domestic economic development. Despite these realities, a number of important things can be done.

At the outset, the advanced industrial nations have it in their power to devise a long-term formula for partially shifting the global pattern of domestic demand—away from the United States and toward surplus countries like West Germany and Japan. Progress has already been made. In order to reduce the U.S. trade deficit, the five largest industrial democracies successfully collaborated in bringing about a systematic decline in the dollar's foreign exchange value *vis-a-vis* the key currencies of West Germany and Japan. The industrial democracies have also been able to formulate a more ambitious *quid-pro-quo*, involving U.S. budget restraint in exchange for more expansion in West Germany and Japan. The U.S. Federal budget deficit in fiscal year 1987 is projected to fall to $161 billion, down sharply from fiscal year 1986's $221 billion. Japan is committed to a $43 billion stimulus package. While more resistant to the idea, Bonn has likewise pared its interest rates and pledges to accelerate the fiscal stimulus if growth continues to lag.

The cumulative U.S. trade imbalance clearly indicates the need for additional, more far-reaching measures by America's trading partners. Two key steps and need to be taken. First, surplus countries—led by Japan and West Germany—ought to consider initiating more stimulatory actions, designed to pull in larger volumes of exports from both the United States and Third World nations. As already noted, this is because the United States continues to generate the bulk of global demand.

This disparity between the United States and its trade partners is most graphically captured in relative import percentages: While the United States continued to pull in about 60 percent of developing world manufacturing products through 1986, Western Europe's proportion came to about 30 percent, while Japan's actually dropped from 8 to 6 percent. In sum, America's partners need to pick up the slack. Stimulating growth in these allied countries would help the U.S. economy to expand through increased exports. Doing so would also provide heavily indebted developing countries with alternative export markets—a key ingredient in any strategy to reduce the burden of Third World external debts.

Developing countries—particularly in Latin America—provided a vital stimulus to global expansion in the 1970's, pulling in large volumes of imports and foreign investment capital. However, except for Asia, growth in these areas has been weak since the early 1980's. In Latin America, for example, it averaged 1 percent between 1980 and 1986, less than 20 percent of the average real GNP growth rate during the previous decade; in the Middle East, real gross national product actually declined over a similar period. One result is that vital Western export markets have virtually dried up. Between 1981 and 1985, the percentage of total U.S. merchandise exports going to the Third World dropped from 41 percent to 34 percent.

In attempting to revitalize these regions, the United States has called for a unified strategy—to achieve simultaneously long overdue market-oriented, structural reforms in the Third World, in return for increased private capital flows. But the United States

cannot be expected to address Third World debt issues alone. As surplus countries, West Germany and Japan should also be encouraged to expand their financial role in these areas. Japan's recent promise to expand its Third World lending by $30 billion comes, then, at a most appropriate moment.

The United States faces substantial trade challenges in the 1980's as a result of large merchandise imbalances and the emergency of new economic competitors. But the United States is also well positioned to compete—thanks to a more realistic U.S. dollar value, the prospect of fairer trade rules, and an innovative industrial and technological base. Furthermore, the United States must continue to fight against protectionism wherever it is found, while reducing its budget deficit.

One additional consideration involves the possibility of establishing a new, separate Department for International Trade. Such an action would not in itself bring about an immediate reversal of the U.S. merchandise imbalance. Properly conceived, however, such an innovation might provide a more centralized focus for the conduct of America's international economic policy.

The international competitiveness of U.S. business has improved markedly recently. In contrast to the rest of the world, unit labor costs in the United States are declining. U.S. productivity has grown faster than it has for most of our trading partners. Many U.S. firms are poised to further expand exports and recapture their share of international markets. Consequently, the trade outlook is brightening, increasing the prospect for stronger economic growth.

What Direction for Monetary Policy?

Chairman Paul A. Volcker's leadership at the Federal Reserve has left an historic legacy: an ending of the inflation of the 1970's, and 56 months of solid economic growth without inflation in the 1980's. The appointment of Alan Greenspan to succeed Paul Volcker suggests the likelihood of some changes in policy at the Board of Governors and at the Federal Open Market Committee, but the new Chairman's known commitment to price stability has helped to maintain a calm continuity in the financial markets since the announcement of his nomination. Long-held fears that the expansion would collapse with the resignation of Chairman Volcker have proven unfounded. Once again our economic system has demonstrated that it truly has a power and will of its own, transcending alleged reliance on public policy personalities.

In the area of monetary policy, the Federal Reserve's direction during the most recent 2-year period has been expansionary. Interest rates declined steeply during 1986, with 3-month Treasury bill rates, for example, declining from 7.04 percent in January to 5.18 percent in October, and finishing the year at the still very low level of 5.49 percent. During 1985 the M1 money supply rose at a 12.5 percent annual rate and during 1986 it continued to grow at 16.5 percent.

In the first half of 1987, however, there has been a moderating of the monetary expansion, with interest rates on the 3-month Treasury bill rising to approximately 5.7 percent. The M1 money supply expansions has slowed significantly. The Federal Open Market

Committee has not indicated any change in current monetary policy or operating procedures to lead to the current moderation in monetary expansion. Indeed, the FOMC has called for "no change in the current degree of pressure on reserve positions" at every meeting recorded in the *Federal Reserve Bulletin*, since August 1986. At that meeting, the FOMC recommended less reserve restraint.

The moderation in monetary policy indicators without an explicit change in policy suggests there is a large endogenous element to monetary policy. The public's demand for liquid assets is an important factor in determining the volume of demand deposits and other checkable deposits in the banking system for any particular volume of monetary base, but in the first 5 months of 1987 the supply of currency grew 9.0 percent, other checkable deposits grew 21.8 percent, but demand deposits decreased by 3.5 percent.

The accumulating evidence about the demand-driven nature of monetary policy poses a serious dilemma for "activist" economic theorists: direct action is unlikely to attain the desired results. We have seen this problem in recent decades, as monetary stimulus produces growth in nominal GNP but the factors that divide that growth between real growth and price increases are not clearly understood.

Thus, a search for "constructive" monetary policy options leaves us counseling prudence and conservatism, at the discretion of the Federal Reserve. The identification of "destructive" monetary policy options includes both any consciously sought increase in monetary growth rates (or further decline in interest rates) and any consciously sought slowing of monetary growth rates, or further increases in interest rates. The emphasis is on the words "consciously sought." Some movement of these economic variables will surely occur, both as the Federal Reserve responds to seasonal reserve needs in the banking system and as the public adjusts its demand for cash balances to expectations and real economic growth. Prudence and a conservative hesitation to accommodate any trend—up or down—seems more likely to produce continued real economic growth without inflation than any "consciously sought" policy to do so could do. Our advice to Chairman Greenspan is to maintain a steady rudder.

Raising the Minimum Wage

The 100th Congress has renewed interest in increasing the minimum wage. At least six bills introduced this year would amend the Fair Labor Standards Act. The most prominent of these would raise the minimum to $4.65 by 1990 and index future levels to the increase in private sector wage rates. However, persuasive evidence shows that the minimum wage is no panacea for higher living standards or the eradication of poverty.[4]

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[4] For further reading, see the following:
Cohodus, Nadine, "Minimum Wage Getting Maximum Attention," *Congressional Quarterly*, Mar. 7, 1987.
"Statement of the U.S. Chamber of Commerce on Efforts To Increase the Federal Minimum Wage." Testimony of William Stone before the Subcommittee on Labor Standards of the House Committee on Education and Labor, May 21, 1987.

Continued

The proven consequences of higher labor costs due to increases in the minimum wage are either fewer hirings or more layoffs. Research from 1977 to 1981 by the Minimum Wage Coalition to Save Jobs, composed of 45 industry associations, points to the loss of 644,000 jobs directly attributable to the 46 percent increase in the minimum wage. A 1983 U.S. General Accounting Office study found "almost complete agreement that the minimum wage has cost jobs." The U.S. Chamber of Commerce estimates that current legislation to raise and index the minimum wage will dampen job creation by some 8.5 million between 1988 and 1995.

Small businesses with tight operating budgets and slim profit margins are particularly sensitive to minimum wage changes. Demographic analysis reveals that teens, minorities, females, and the disadvantaged suffer from minimum wage legislation purported to benefit them. A consensus of analysts suggests that a 10-percent hike in the minimum wage leads to a 0.5- to 3.0-percent increase in teen unemployment, relative to a constant minimum wage. Teens and young adults are the least experienced and most expendable laborers, thus their vulnerability to mandated labor cost increases. The vast majority of lost jobs are those of low skilled bussers, messengers, clerks, and the like. Most of these jobs are held by those who need to gain experience and to scale the socioeconomic ladder.

Employers facing higher labor costs not only reduce labor requirements, but also reduce or eliminate fringe benefits, such as health care insurance and pension plans. On-the-job training also is cut back, to the long-term detriment of lower income laborers. Without extensive job training, workers' lifetime earnings potential is reduced, thereby condemning unskilled workers to a career of low-paying jobs.

Who has benefited from minimum wage legislation? According to Peter Linneman of the University of Pennsylvania, labor unions and their members have gained the most. This occurs in two ways. First, raising the wage floor has the effect of raising all wage rates. Second, the economic value of some workers may not be equivalent to the minimum wage. When that happens, employers logically seek workers who may be paid more but also are more productive and cost effective. Linneman's research states that the 1974 minimum wage increases resulted in a $400 per year increase for union workers while non union workers lost income.

The ill effects of minimum wages have a geographic implication, too. Marshall R. Colberg of the American Enterprise Institute notes that cheap labor areas, such as the South, lose their advantage over more expensive labor areas, such as the Northeast, when wage floors are imposed.

"Minimum Wage Policy Questions Persist," U.S. General Accounting Office report to the Committee on Labor and Human Resources, U.S. Senate, June 28, 1983.

Linneman, Peter, "The Economic Impacts of Minimum Wage Laws: A New Look at an Old Question," *Journal of Political Economy*, vol. 90. No. 31, 1982.

Colberg, Marshall R., "Minimum Wages and the Distribution of Economic Activity," *Economics of Legal Minimum Wages*, American Enterprise Institute, 1981.

"Minority Views," *Report of the Minimum Wage Study Commission*, vol. 1, chap. 10, May 1981.

Whittaker, William G., and Ciccone, Charles V., "The Fair Labor Standards Act Amendments of 1977," Congressional Research Service publication No. 78-171E, Aug. 15, 1978.

"The Minimum Wage: Its Relationship to Incomes and Poverty," Congressional Budget Office staff working paper, June 1986.

Indexing would only serve to exacerbate the ill effects caused by the minimum wage. This issue has been clouded in the political arena as well. The Minimum Wage Study Commission, a highly partisan group appointed by President Carter, recommended indexing. In doing so, one of its members, S. Wayne Robinson, noted in his dissenting views that the Commission ignored almost all of the sound economic advice and evidence presented to it. Indexing likely will cause these four problems: (1) Marginally profitable firms employing low-skilled workers would be forced out of business as automatic labor cost increases are imposed. (2) Indexing can be inflationary, and automatic increases would be mandated without regard to other important economic factors. (3) Pay increases traditionally represent rewards for productivity increases, new training and more responsibility. Mandated pay raises for the low skilled remove the very important ingredients of incentive and initiative from the workplace. (4) Automatic provisions can lead to decreased oversight by Congress, making policymakers less responsive to economic problems.

Proponents of raising the minimum wage have portrayed minimum wage earners as established workers struggling to keep their families out of poverty. This depiction is hardly the norm, however. Only a small fraction of all minimum wage workers are the sole or major income earner for the family. Instead, most are new entrants to the work force, students working part time or family members earning supplemental income. Some 60 percent of all minimum wage workers are under age 25, an age group that has the most to lose when changes in the minimum wage are legislated. Furthermore, four-fifths of all minimum wage earners are not poor.

Contrary to the proponents' depiction of minimum wage workers, just 10 percent—or 0.7 percent of the total work force—are heads of households with three or more persons. These 670,000 sole wage earners likely are facing poverty conditions that can be addressed through far more effective means than minimum wage increases—such as earned income tax credits, housing and food assistance, and Medicaid.

The concept of a national minimum wage was forwarded as part of the New Deal. But times have changed. The U.S. economy is currently approaching the longest sustained peacetime expansion in its history. Millions of jobs have been created in the United States in the last 4 years while all European nations have had little job growth. Inflation has fallen dramatically from the double-digit levels of the late 1970's. The poverty rate has declined. This, and much more, has been accomplished without any increase in the minimum wage.

IV. POLICIES FOR A CHANGING DOMESTIC AND WORLD ECONOMY

Structural change is the inevitable result of economic growth. This follows from the first principle of economic theory, the existence of scarcity. Because we do not have unlimited resources with which to meet our unlimited wants, individuals and societies must make tradeoffs based on their ranking of relative value. This defines the concept of relative prices.

A change in the output of a good or service requires increased or diminished use of at least one factor of production, which in turn causes a change in relative prices. As factor flows shift in response to this price change, we have structural adjustments. Attempts to artificially prevent these changes result in surpluses and shortages. The only way to avoid structural change and the dislocation that accompanies it, is to accept economic stagnation—zero growth could produce zero change. This is not a viable option for any society.

Therefore, any discussion of policies for dealing with changes, domestic or global, should have as their goal facilitating the adjustment process, not the prevention of the shifts. The first section of this chapter will examine the Government's role in aiding the adjustment process with the following section giving specific consideration to the international aspects of structural change and economic growth.

The Role of Government in Facilitating Change

While economic growth leads to structural change, a strong, expanding economy is also the most efficient method for easing the dislocation of the transition. Labor in particular benefits when, through economic expansion, new jobs are created even as old jobs disappear due to productivity improvements, changing consumer demand, or a shift in international relative production advantage. Additionally, the benefits of economic growth help create resources that can be used, for example, in retraining and relocation, in improving the quality of education, and in increasing the availability of health care.

Public policies in support of economic growth should be focused on the long term. Too often, it appears that policymakers react to shortrun fluctuations with tools more appropriate for longrun structural shifts. A particular change in the tax laws may be viewed as desirable with the hope of improving the next quarter's productivity. Similarly, an increase in the money supply may be called for with the hope of stimulating the next quarter's level of consumer spending or a money supply decrease to dampen quarterly variation in the rate of inflation.

Because the bulk of the effects from these types of fiscal and monetary shifts occur only after a time lag, continuous alterations in these policies in response to shortrun variations will achieve the same effect on the economy as tossing several rocks into a pond: the interference caused by the intersections of the wave patterns from rocks thrown later will cause combined peak and trough effects that were not predicted because the effects of previously thrown rocks were not taken into account.

Therefore the Federal Government and the Federal Reserve need to refrain from reactionary policy behavior that deals exclusively with the short run without consideration of the long-term effects. The Government's responsibility is to create an environment in which growth can occur. As stated in the 1987 *Economic Report of the President*, the principal contribution of the Federal Government to support economic growth "is to maintain a stable macroeconomic environment and to allow the natural incentives of the flexible, private enterprise system to stimulate individuals and businesses to increase the quantity and enhance the quality of productive resources, to improve the efficiency of production processes, and to deploy the Nation's resources to their highest valued uses" (p. 64).

The potential for negative effects arising from government action increases with an increase in the degree of governmental intervention in the private sector, and not always with a corresponding increase in the potential for a positive result. While it is generally accepted that the U.S. economy is much too large and complicated for any type of national planning scheme to work, there is still a tendency, particularly with a specific troubled region or sector of the economy, to try to intervene. While regional or sectorial intervention is not always detrimental to the long-run health of the economy, extreme care must be exercised to provide assistance consistent with the underlying structural reality. Moreover, direct intervention in any one sector or region will have many effects, some impossible to predict, on other sectors and regions.

One of the primary strengths of market system is its allowance for individual decisionmaking—this is the basic process of risk diversification for the economy. Government intervention disrupts this process, producing results that are only sustainable through greater and greater control. Ultimately, intervention can defeat its own purpose.

Economic growth occurs only with change, both domestic and international. In response to shifts in demand, relative costs of inputs, and technology, businesses must make their production choices. The role of government, in supporting these changes, shoulds be to remove barriers limiting or restricting the options available. These barriers include policies that unnecessarily prohibit or artificially raise, through regulation, the cost of alternative activities.

Another problem with interventionist policies is that very detailed data are required to make informed decisions. Before any policy changes can be considered the Government should have good information as to the current situation, which underscores the importance of collecting quality economic statistics. A recent interagency task group composed of representatives from the statistical

gathering agencies reported that several major data improvement initiatives are underway and the Federal data collection system is basically sound. They did, however, identify five high-priority areas where additional attention and effort are needed.

Even when these improvements are implemented, our current data collection system would not be capable of providing the extremely specific data that would be needed on a timely basis if some type of sectorial intervention were considered. It is doubtful that any centralized data collection agency could provide this type of information. The use of knowledge in business decisionmaking is highly specific to changing circumstances of time and place.

Economic Change: The Global Context

The U.S. trade deficit is sometimes given as a reason for sectorial intervention. Many feel that industry-specific competitiveness problems have been a leading cause of the unfavorable balance-of-trade we are now experiencing. If proponents of this position are correct, then perhaps sectorial intervention, on a case-by-case basis should be undertaken. However, a study just issued (May 1987) by the Federal Trade Commission (FTC) does not support this view.

This report, *International Competitiveness and the Trade Deficit* by Hilke and Nelson, provides an econometric analysis supporting the view expressed in the 1987 *Economic Report of the President* which concludes that changes in exchange rates and relatively rapid U.S. growth in demand underlie the trade deficit. In addition to these economywide or macro explanations, the FTC considered seven industry-specific explanations that have been proposed as possible causes of our trade problems. The possible explanations examined were: (1) Foreign trade practices, (2) inadequate investment, (3) declining research and development, (4) high labor cost, (5) union work rules, (6) the OPEC cartel, and (7) antitrust restrictions on industry cooperation.

The FTC found that while an individual industry's imports and exports are affected by these factors, there have been no significant industry-specific changes that would have affected the overall trade deficit.

The authors conclude, "Sorting out the sources of recent trade deficits is important, since identifying the origin of the trade deficits helps determine what government actions, if any, are appropriate. Specifically, if transitory phenomena such as changing exchange rates and extremely rapid U.S. growth underlie the deficits, policy prescriptions based on concerns about industry-specific competitiveness will be misguided" (p. xvii).

These results do not imply that we should be allowing unfair trade practices currently prohibited by law. We must enforce existing laws that prohibit illegal behavior such as dumping. However, we must be cautious of rhetoric aimed at unfair trade, but actually intended to establish protectionist barriers. This FTC study indicates that the establishment of barriers, such as tariffs and quotas, "may, for example, disrupt imports in one industry, but since the overall trade accounts must balance, imports are likely to increase in some other industry. Such disruptions and shifts in imports usually occur in ways that are economically inefficient, penalize ex-

porters and other producers, and are costly to U.S. consumers" (pp. xix-xx). The benefits of change (economic growth) are not lost if the change is caused by international shifts as opposed to domestic shifts, provided these changes are real and not transitory market manipulation.

Technological Innovation: What Role for the United States?

From its beginnings, the United States has been at the forefront of technology development, both in creating new products and processes and in bringing these inventions to the marketplace. This technological preeminence has been an important contributor to our growing high standard of living. Recently, however, there has been concern expressed that the United States is beginning to lose this important competitive edge. Although the United States still ranks first in many measures of innovative activity, the growth rates of several other industrialized countries have been larger than the United States for the last few years.

As part of the program to ensure our continued ability to compete effectively in global markets, the Reagan Administration has increased aggregate funding of science and technology programs by 84 percent since 1981. In the 1987 State of the Union Address, the President again emphasized the importance of enhancing international competitiveness through technological competitiveness. The program he presented stressed "improved science, technology, and engineering education, the establishment of more science and technology centers, increasing the NSF budget, enlarging programs of domestic technology transfer, accelerating spinoff of defense to civilian technology, and pursuing such specific R&D initiatives as construction of a space station, plant sciences, the National Aerospace Plane, and mapping and sequencing human NDA" (CRS *Science and Technology Policy and Funding: Reagan Administration,* May 1987).

The Reagan Administration's philosophical orientation to the support of research and development involves the following points:

- Use of the private sector.
- The preeminence of economic recovery and the need to support basic research promising potential economic payoff.
- Strengthening of the Nation's military posture.
- Decreasing the Federal role in favor of the States. (*Ibid.*)

This underlying philosophy is fundamental to the view of the Federal Government as the facilitator of economic growth. It balances the legitimate role of government as the producer of public goods such as defense, education, and basic research, with the role of industry as the producers of developmental and applied research.

The Federal Government also has a role in encouraging private R&D through its tax policy. Not only should the incremental R&D tax credit spur new innovative activity, but the increased equity of the new tax system should encourage resources to move to the most efficient uses. Given the importance of the R&D tax credit, the Congress should give serious consideration to make the credit permanent. Research shows the R&D investment has a high payoff, not only for those industries generally thought of as high tech, but

also for most of manufacturing. For example, a recent Congressional Research Service study by David Cantor (June 10, 1987) reports that the improvements in the development and deployment of new steel technologies were an important contributor to the 50-percent increase in productivity experienced by the U.S. Steel industry during the 1980's.

While important steps have been taken to firm up our technological base, there remain important policy issues to be considered. One of these is the effect of new technologies on our ability to protect intellectual property rights. Our current system is no longer adequate to deal with the problems resulting from worldwide technological growth. Rapid changes in this area have made it exceedingly difficult to balance the rights and needs of creators, producers, and distributors of intellectual properties with the rights of users. Since property rights in general are a system for the allocation of incentives and rewards, they are important stimuli for innovation. If we are unable to protect the economic return of successful inventors, then the United States may lose an important source of economic growth.

V. CONCLUSION

Setting and surpassing the peacetime expansionary record is no cause for celebration if we rest on our laurels come October. Indeed, a renewed dedication and rekindled American spirit may be the order of the day. By interesting coincidence, the economic growth milestone will be attained at the very time the U.S. constitutional form of government ventures into its third century.

Has the bicentennial commemoration of the Constitution influenced the current expansion? As implausible as that may seem, those two events are connected in America's origins. The Constitution is directly related to and partially responsible for making our nation the strongest and most abundant in history. The economic principles championed by President Reagan have their foundation in constitutional economics. In this important respect, the record-breaking expansion and the renewed interest in the Constitution are closely linked.

In the past few years, scholars of economics and government have poured over the Constitution, its historical setting and supportive documents such as *The Federalist Papers*. This new research has uncovered evidence of astute economic thought that has remarkable application two centuries later. Our heritage is a political economy where the citizenry is afforded freedoms but at the price of certain, unavoidable responsibilities. Our government is neither sacred nor infallible. Noble as society's desires and intentions may be for mankind, history has proven that government is not always the best motivator of people, the fairest allocator of resources or the outstanding facilitator of economic progress. Therefore, there are limits on how much government can or should do. Sole reliance on government is a sorry and inadequate substitute for confidence in people themselves.

After the record has been surpassed and the Constitution's anniversary is over, is it business as usual for the United States of America? We hope not. The 1980's have provided clear evidence that our economy is in transition. Services and information are the emerging growth sectors. Much of our growth potential hinges on our ability to compete in the global economy. Status quo responses to a changing economic landscape are flatly unacceptable if we are serious about America's prominence in the world arena. Economic hindrances—such as labor-management strife, burdensome taxation, and heavy regulation of individuals and businesses—will sap our vitality while other nations boldly go forward.

Technology is the leading edge that may determine the direction and fate of the United States. Our foreign allies are now our formidable competitors in the technological domain. Harnessing the obvious economic benefits of breakthroughs in semiconductors; superconductivity; space-based exploration, experimentation, and production; medical science; and advanced communication and commer-

cial travel will elevate living standards and lifestyles in ways unimaginable a generation ago. It is America's destiny to fulfill mankind's curiosity, creativity and quest for new frontiers. To forsake this purpose is to relegate the United States to a lower and defeatist status in the world and in history, and to deny the least privileged in our society the potential for advancement.

The reaffirmation of free enterprise and entrepreneurship has made an invaluable contribution to the current economic expansion. Continuing a climate that is hospitable to opportunity can only lengthen and strengthen it.

DISSENTING VIEWS OF REPRESENTATIVE OLYMPIA J. SNOWE

While I have joined in signing this report, I do differ on some of its specific issues and passages. Without delineating each specific phrase or sentence, I would point to the discussion of poverty and minimum wage, for example, as subjects on which I and others may have legitimate differences, over analysis or conclusions or both.

In addition, I am in disagreement with the midyear report's discussion of the U.S. trade situation, and to problems the United States faces due to unfair foreign trade practices.

In general, I disagree with the conclusion that promoting world economic growth, without a much greater emphasis on trade equity for U.S. industries, is a sufficient policy to respond to the current trade crisis. The report's focus on resolving trade problems through overall economic growth ignores the underlying inequities in international trade today.

The report states that multilateral negotiations, the further decline of the U.S. dollar, improving U.S. export capacity, and other factors will help restore U.S. export competitiveness. While these factors are important, they cannot adequately address the real negative aspects of the current trade picture for the United States. For example, other nations do deliberately target their products and deliberately exclude our products from their shores. As I pointed out in the *1987 Joint Economic Report*, Japan limits footwear imports to about 1 million pairs, while Brazil imposes tariffs which effectively block any significant imports. Meanwhile, the U.S. imports over 900 million pairs of shoes annually. Other countries, using footwear production and export strategies, have picked as a target the ever-inviting American market. Their successes, plainly, can be attributed to far more than straightforward competitive advantages.

So long as these unfair trade practices exist and trade challenges from abroad are unmet, industries and workers in the United States will continue to be at a pronounced disadvantage regardless of further changes in currency levels and the level of growth in the economy. This lack of responsiveness to the trade-related problems of our domestic industries remains a stumbling block which the current trade reform legislation, now before the Congress, makes moderate attempts to correct.

The experience of the domestic shoe industry is a vivid illustration of that fact. After a lengthy process, the International Trade Commission unanimously ruled that the footwear industry had been materially injured. The President, however, rejected the subsequent recommendation by the ITC for trade relief in 1985. Since that time, 14 shoe factories have closed, hundreds of jobs have been lost in the State of Maine alone, and the level of import penetra-

tion for footwear nationwide has risen from 75 percent to the current level of 84 percent.

While the report endorses the positive aspects of "sensible revisions of U.S. trade statutes," the report's stronger message is that the United States should not cause trade frictions with our economic partners.

Furthermore, the report adheres to a position which uses the ill-defined word of "protectionism" essentially as a definition of any effort to gain a fair trade response for U.S. industries. Industry efforts to pursue the legitimate enforcement of our trade laws have been met far too often with assertions that such actions are "protectionist." In the report's words, "resorting to protectionism hardly constitutes a viable economic strategy for the world's largest, most dynamic economy." What this statement really means is that we can't do anything that might serve to alienate our trading partners. But to that, I would ask: Have our trading partners hesitated, in their dumping of products and trade barriers to alienate us? And, if they were alienated, wouldn't they continue the unfair trading practices they initiated?

I believe we simply can no longer afford to delude ourselves about our $170 billion merchandise trade deficit. The United States has ignored the way in which foreign governments manipulate international trade. The volatility of the worid economy is skewed and unsettled further by the range of subsidies, barriers and restraints of trade imposed by other nations. No longer can the United States afford to remain indifferent to the actions of other nations.

Thus, we are a lone participant in our approach to trade, and this stance is one of obsolescence and naivete. From 1982 to 1985, the United States absorbed 55 percent of manufactured products exported by developing countries. Japan, on the other hand, absorbed only 9 percent from the LDC's. We must also be concerned about our service industries, which are now critical toward holding down unemployment and sustaining per capita income. From 1983 to 1985, the United States went from a $1.35 billion surplus in our service trade with Japan to a $1.8 billion annual deficit.

In sum, we must also look to a more concerted response by the United States to the modern day challenges of the international marketplace. We must pursue a strengthening of our trade laws, a much stronger enforcement of these laws, and a real commitment to stand behind U.S. industries that desire an opportunity to fairly compete. If we do nothing, the United States will continue to serve as the punching bag of international trade.

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